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Durgesh Chopra
212-653-8998
Durgesh.Chopra@evercoreisi.com
Jeffrey Qiu
212-446-5626
Jeffrey.Qiu@evercoreisi.com
Greg Gordon, CFA
212-653-9000
greg.gordon@evercoreisi.com

Water Utilities Q2 2019 Earnings Recap

The sector continues to look expensive to us on both an absolute and relative basis. Water utilities in our coverage universe are currently trading at a 30x P/E multiple on ‘21E EPS versus our fair value estimate for the space at 23x (58% / 75% premium to the electric utilities / S&P 500, respectively, versus the 10-year average of ~35% / ~50% based on a one-year forward P/E). 2Q19 earnings results were a mixed bag for the water utilities; see our key takeaways by company below.

AWK ($108PT, Outperform). 2Q19 EPS of $0.94 was a penny higher than consensus.

- The quarter benefitted from ~$0.10 EPS uplift from one-time items (land sales etc) offset by wet weather impact of $0.05.
- FY ’19 adjusted EPS guidance range of $3.54-$3.64 was reaffirmed. The long-term EPS CAGR is still projected to be in the top half of the 7-10% range anchored off ’17 adjusted EPS of $3.03, with dividends expected to grow at the high end.
- Capex guidance for the year was raised $100mm to $1.9bn, primarily driven by regulated acquisitions.
- We continue to struggle with the valuation for water utilities in our coverage universe. Despite a NTM total return proposition of -9% under our base case scenario (group average is around -11%), we think AWK offers the most attractive risk / reward proposition among our coverage universe over the long term, remain **Outperform**.

AWR ($60PT, Underperform). AWR reported 2Q19 adjusted EPS of $0.64 vs consensus of $0.56.

- Quarterly dividend was increased 10.9% and long term they are now targeting more than 7% compounded annual dividend growth (vs more than 6% previously)
- Company’s proposed water rate case settlement was approved by the commission; gross margin is expected to increase by $7mm / $10mm / $12mm in ’19 / ’20 / ’21, respectively.
- The commission issued a proposed decision in the ongoing electric rate case approving the settlement reached between the company and various parties. If approved, the rate increase would be retroactive, beginning 1/1/18.
- Reaffirmed ASUS 2019 EPS guidance range of $0.43 to $0.47, consolidated capex this year is still expected to be in the $115mm to $125mm range.
- We are raising our ’19 / ’20 / ’21 EPS forecast to $2.00 / $2.10 / $2.25, driven by better than expected results YTD.
- Raising target price from $57 to $60, remain **Underperform.**

CTWS ($70PT, In Line). CTWS reported 2Q19 EPS of $0.48 vs prior year EPS of $0.39.

- The company filed an updated settlement agreement related to the SJW / CTWS merger application in CT. The one key addition to the previous application filed on 4/3/19 was that of rate credits totaling $300k/yr for a period of ten years, starting with the next general rate case (~$0.01 annual EPS impact before offsets). The agreement provides the companies with the opportunity to offset these credits with merger-related cost savings.
- SJW and CTWS expect the transaction to close in the third quarter of 2019, be neutral to slightly dilutive in the first full year, and be high-single-digit EPS accretive in the second full year post-closing.
- We are maintaining our $70 target price and **In Line** rating.

CWT ($46PT, In Line). CWT reported 2Q19 EPS of $0.35 vs consensus of $0.38.

- They are in settlement discussions in their ongoing rate case in CA. Recall they had filed their GRC in CA on 7/2/18, requesting $828.5mm in capital spend from '19-'21. The rate increase application requests $50.7mm / $31.5mm / $33.0mm revenue increases for years '20-'22, respectively. The company expects a final decision by YE '19 with rates effective 1/1/20.
- The company is dealing with a new variable: Public Safety Power Shutoffs (PSPS). Electric companies have been authorized to shut off the grid in addressing wildfire risk. They have redirected staff resources towards internal operational / wildfire readiness training, as well as hardening of their system for wildfires. They expect $2-3mm in equipment leases costs in 2H19 (59 generators for wildfire response)
- CWT's cost of capital filing is due in March next year. Currently they are approved for an equity / debt layer of 53% / 46%, and an ROE / cost of debt of 9.2% / 5.5%, respectively.
- We are maintaining our $46 target price and **In Line** rating.

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SJW ($62PT, In Line). SJW reported 2Q19 EPS of $0.47 vs consensus of $0.56. Excluding one-time items, second quarter adjusted EPS came in at $0.58 versus $0.72 in the prior year.

- The company filed updated settlement agreement related to SJW/CTWS merger application in CT. The one key addition to the previous application filed on 04/03/19 was that of rate credits totaling $300k/yr for a period of ten years, starting with the next general rate case (~$0.01 annual EPS impact before offsets). The agreement provides for the companies' opportunity to offset these credits with merger-related cost savings.
- SJW expects the transaction to close in the third quarter of 2019, be neutral to slightly dilutive in the first full year, and be high-single-digit EPS accretive in the second full year post-closing.
- They settled with the California Public Utilities Commission (CPUC) over past customer billing practices. If approved by the Commission, the company would pay ~$2.1mm in one-time customer credits ($0.06 EPS hit booked in Q2) and invest $5.0mm in utility plant without seeking an investment return or rate recovery (<$0.01 EPS hit).
- In Texas (which represents ~5% of total EPS) legislations SB-700 and HB-3542 will take effect 09/01/19: the former will allow water utilities to recover and earn a return on capex in-between rate cases (similar to DSIC/infrastructure surcharges mechanisms in other states); HB-3542 allows a utility in Texas to value acquired assets at fair market value for ratemaking purposes.
- We are maintaining our $62 target price and **In Line** rating.

WTR ($37PT, In Line). 2Q19 adjusted EPS of $0.37 was largely in line with expectations and flat to prior year.

- The Peoples Gas acquisition is still expected to close in fall of this year. A settlement agreement has been filed with the administrative law judge with a recommended decision expected later this month, and a final PA commission order is expected in the fall. On the rate case front, a settlement agreement seeking $59.5mm in gas rate increase is awaiting commission approval. New rates are expected to go into effect in October 2019.
- Potential acquisition of a PA-based wastewater operator DELCORA may be in the cards (~$300mm rate base and ~$0.03 EPS uplift, by our estimate).
- Repair tax pass-through could be pursued next year, and could be up to $0.10 EPS accretive ($2/sh or 5% valuation uplift).
- Long-term guidance is expected to be issued in December '19; we are maintaining our $37 price target for WTR and **In Line** rating.

Exhibit 1
AWK Valuation Framework

Scenario	EPS CAGR*	'21EPS	'20 P/E	Valuation	Tot. Return
Base Case	7.9%	$4.10	26.5x	$108	-9%
Bull Case	9.3%	$4.32	27.8x	$120	1%
Bear Case	7.0%	$3.97	25.1x	$100	-15%

**17 through '21*

Valuation: Our $108 price target is 26.5x our FY '21 EPS estimate of $4.10/share. That is a ~15% premium to our water utility average target multiple of 23x, due to the company's best-in-class earnings and dividend growth, as well as geographical / regulatory diversity. The latter not only minimizes regulatory risks, but also offers a competitive advantage to capitalize on industry consolidation opportunities, given AWK's presence in 16 states. Our bull case valuation of $120 for AWK assumes growth in the upper half of their targeted 7-10% EPS growth guidance range and a 5% premium to a '21 P/E multiple of 26.5x. Our bear case valuation of $100 assumes AWK can grow earnings at the low end of the targeted 7-10% growth range and we apply a 10% discount to a '21 P/E multiple of 26.5x.

Source: Evercore ISI Research

Exhibit 2
AWR Valuation Framework

Scenario	EPS CAGR*	'21EPS	'20 P/E	Valuation	Tot. Return
Base Case	9.2%	$2.25	26.5x	$60	-27%
Bull Case	10.0%	$2.30	27.8x	$64	-23%
Bear Case	8.2%	$2.19	25.1x	$55	-33%

**18 through '21*

Valuation: Our $60 price target is 26.5x our FY '21 EPS estimate of $2.25/share. That is a ~15% M&A premium to our water regulated target multiple of 23x. Our bull case valuation of $64 for AWR assumes they can grow EPS at 10% through '21 and trade at a 5% premium to our base case '21 P/E multiple of 26.5x. Our bear case valuation of $55 assumes that they grow earnings at 6.5%, 100 bps lower than our base case and trade at 5% discount to our '21 base case P/E multiple of 26.5x.

Source: Evercore ISI Research

Exhibit 3
CTWS Valuation Framework

Scenario	EPS CAGR*	'21EPS	'21 P/E	Valuation	Tot. Return
Base Case	7.1%	$2.75	25.3x	$70	2%
Bull Case	8.1%	$2.83	26.6x	$75	9%
Bear Case	6.1%	$2.67	24.0x	$64	-6%

**18 through '21*

Valuation: Our $70 price target is 25.3x our FY '21 EPS estimate of $2.75/share. That is a ~10% M&A premium to our water regulated target multiple of 23x. Our bull case valuation of $75 for CTWS assumes they can grow EPS at 8.1% 100 bps higher than our base case forecast and trade at a 5% premium to our base case '21 P/E multiple of 25.3x. Our bear case valuation of $64 assumes that they grow earnings at 6.1%, 100 bps lower than our base case and trade at 5% discount to our '21 base case P/E multiple of 25.3x.

Source: Evercore ISI Research

Exhibit 4
CWT Valuation Framework

Scenario	EPS CAGR*	'21EPS	'21 P/E	Valuation	Tot. Return
Base Case	8.7%	$1.75	26.5x	$46	-14%
Bull Case	9.7%	$1.80	27.8x	$50	-6%
Bear Case	7.7%	$1.70	25.1x	$43	-19%

**18 through '21*

Valuation: Our $46 price target is 26.5x our FY '21 EPS estimate of $1.75/share. That is a ~15% M&A premium to our water regulated target multiple of 23x. Our bull case valuation of $50 for CWT assumes they can grow EPS at 9.7% 100 bps higher than our base case forecast and trade at a 5% premium to our base case '21 P/E multiple of 26.5x. Our bear case valuation of $43 assumes that they grow earnings at 7.7%, 100 bps lower than our base case and trade at 5% discount to our '21 base case P/E multiple of 26.5x.

Source: Evercore ISI Research

Exhibit 5
SJW Valuation Framework

Valuation	Post Merger	No Merger	Base Case (a)
Consolidated 2021 EPS	$2.55	$2.30	
Forward P/E Multiple	25.5x	25.5x	
Implied Valuation	$65.0	$59.0	$62.0
Current Stock Price (07/25/19)	$64.3	$64.3	$64.3
Price Appreciation	1.1%	-8.2%	-3.6%
Dividend Yield	1.9%	1.9%	1.9%
Total Shareholder Return	3.0%	-6.4%	-1.7%

Valuation	Bull Case	Bear Case
Consolidated 2021 EPS	$2.55	$2.30
Forward P/E Multiple	26.5x	24.5x
Implied Valuation	$68.0	$56.0
Current Stock Price (07/25/19)	$64.3	$64.3
Price Appreciation	5.8%	-12.9%
Dividend Yield	1.9%	1.9%
Total Shareholder Return	7.6%	-11.0%

Valuation: Our base case valuation of $62 is an average of our post-merger and no-merger valuations. Firstly, our $65 post-merger valuation is based on a pro-forma FY '21 EPS estimate of $2.55 and a 25.5x P/E multiple, which represents a ~10% M&A premium to our regulated water target multiple of 23.0x. Secondly, our no-merger valuation of $59 is based on a standalone FY '21 EPS estimate of $2.30 and a 25.5x P/E multiple. In our bull case of $68, we assume that the merger goes through and assign a 1.0x higher P/E multiple vs. the base case. In our bear case valuation of SJW, we assume the merger is not consummated and assign a 1.0x lower P/E multiple vs. the base case.

Source: Evercore ISI Research

Exhibit 6
WTR Valuation Framework

SOTP Valuation (Base Case)	'21E	'21 P/E	Valuation
Legacy WTR EPS	$1.16	23.0x	$27.00
Gas EPS	$0.48	21.2x	$10.00
	$1.65		$37.00

SOTP Valuation (Bull Case)	'21E	'21 P/E	Valuation
Legacy WTR EPS	$1.16	24.1x	$28.00
Gas EPS	$0.48	22.3x	$11.00
	$1.65		$39.00

SOTP Valuation (Bear Case)	'21E	'21 P/E	Valuation
Legacy WTR EPS	$1.16	20.7x	$24.00
Gas EPS	$0.48	19.1x	$9.00
	$1.65		$33.00

Valuation: Our $37 target price is based on a SOTP valuation where we assign 23x P/E to earnings contribution from the legacy water business and ~21x to earnings from the gas segment. The 23x water P/E is in line with our water regulated peer average target multiple .The gas multiple of ~21x is also in line with current gas LDC trading valuation multiples. Our bull case valuation of $39 assumes that both the water and gas segment trade at 5% premium to our base case scenario. Our bear case valuation of $33 assumes 10% discount multiple to our base case scenario for both segments.

Source: Evercore ISI Research

Risks. Risks to our thesis include an unfavorable regulatory outcome leading to lower rate base growth and/or lower allowed or earned ROEs in ongoing and future rate cases. Other risks include exposure to unusual weather, impact of conservation awareness of customers and more efficient plumbing fixtures and appliances on water usage per customer, cyber security and water contamination.

TIMESTAMP

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Buy- Return 10% to 20%
Neutral - Return 0% to 10%
Cautious- Return -10% to 0%
Sell- Return< -10%

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Hold	295	40	Hold	154	52
Sell	40	5	Sell	15	38
Coverage Suspended	21	3	Coverage Suspended	16	76
Rating Suspended	7	1	Rating Suspended	2	29

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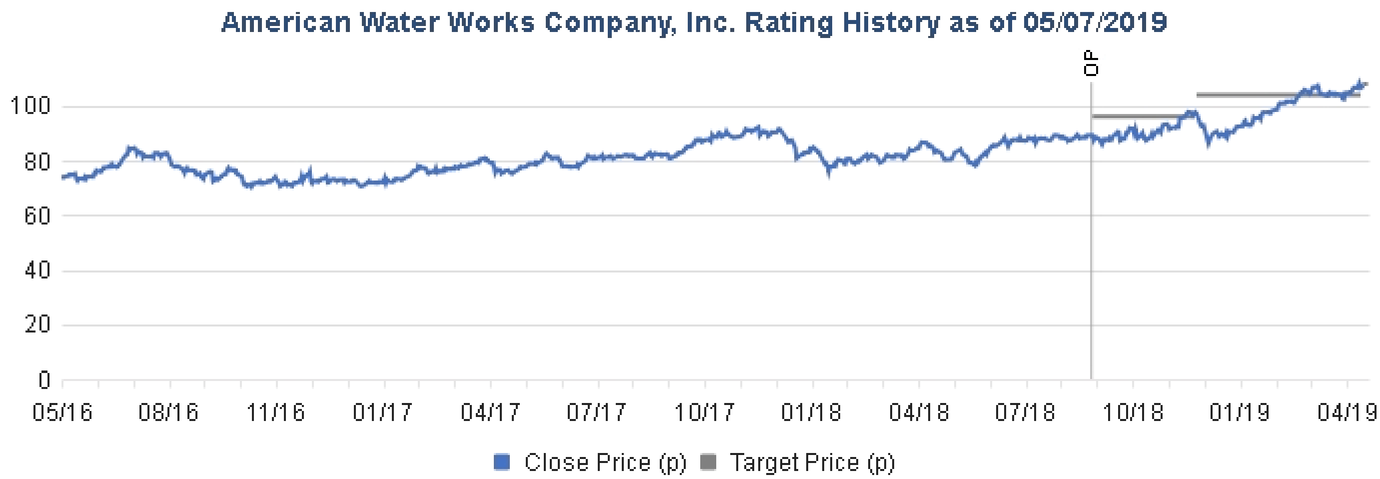

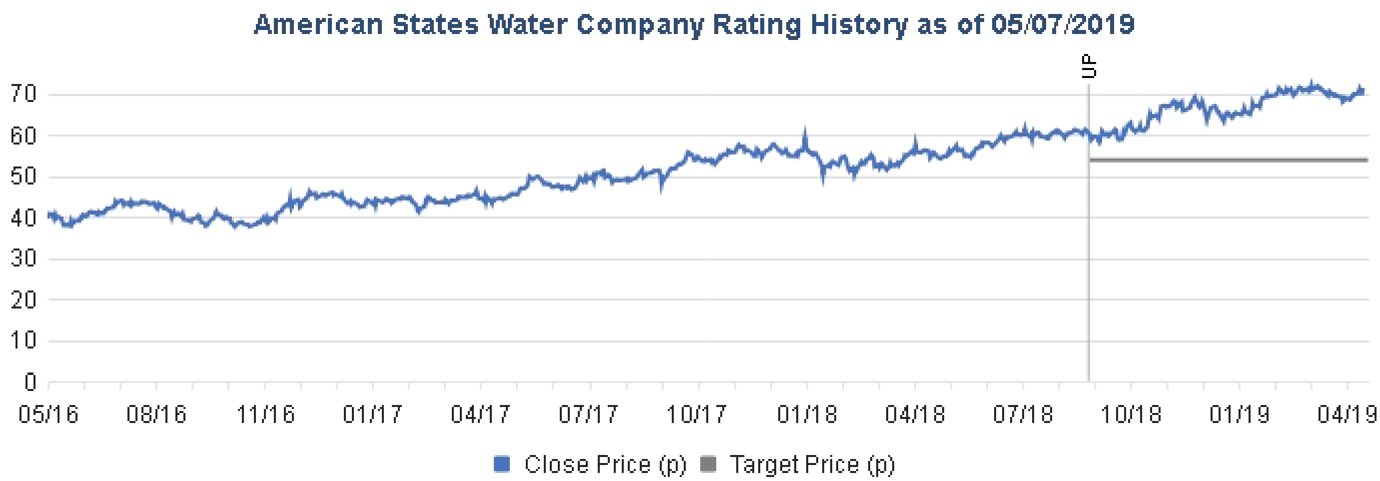

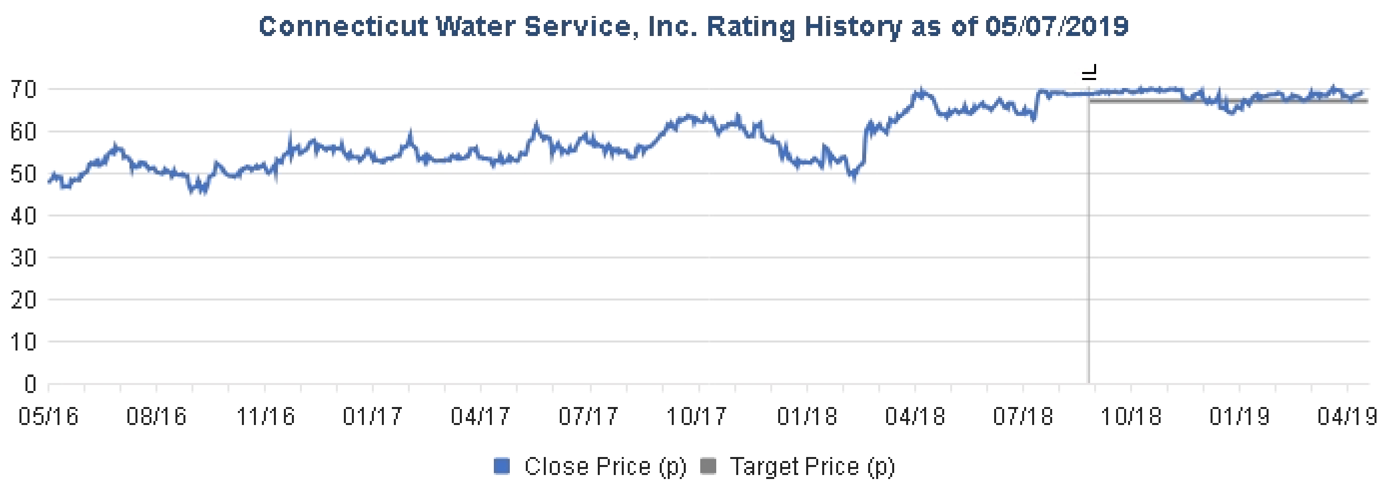

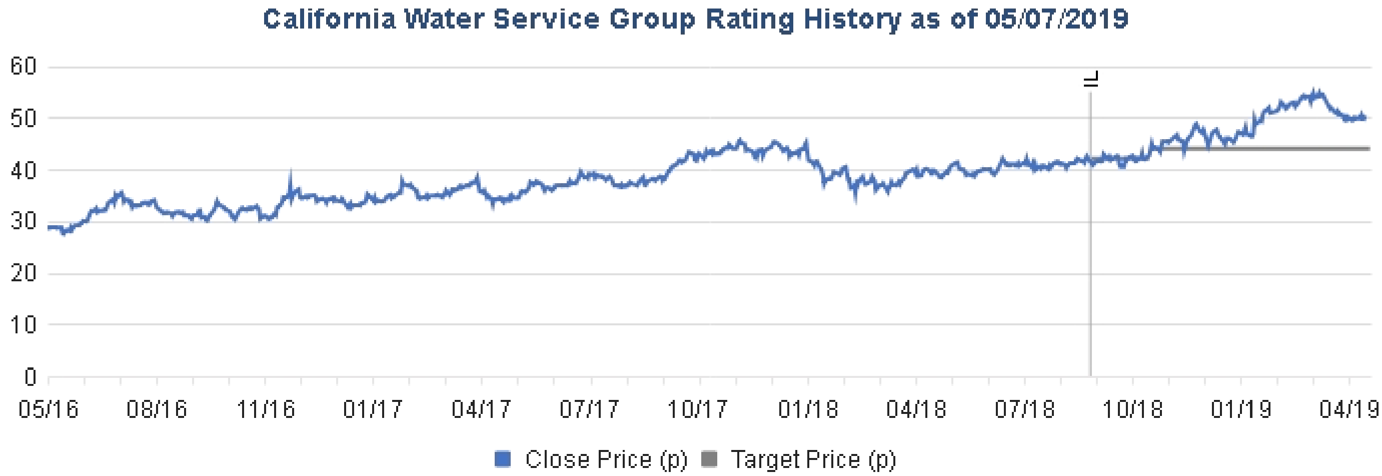

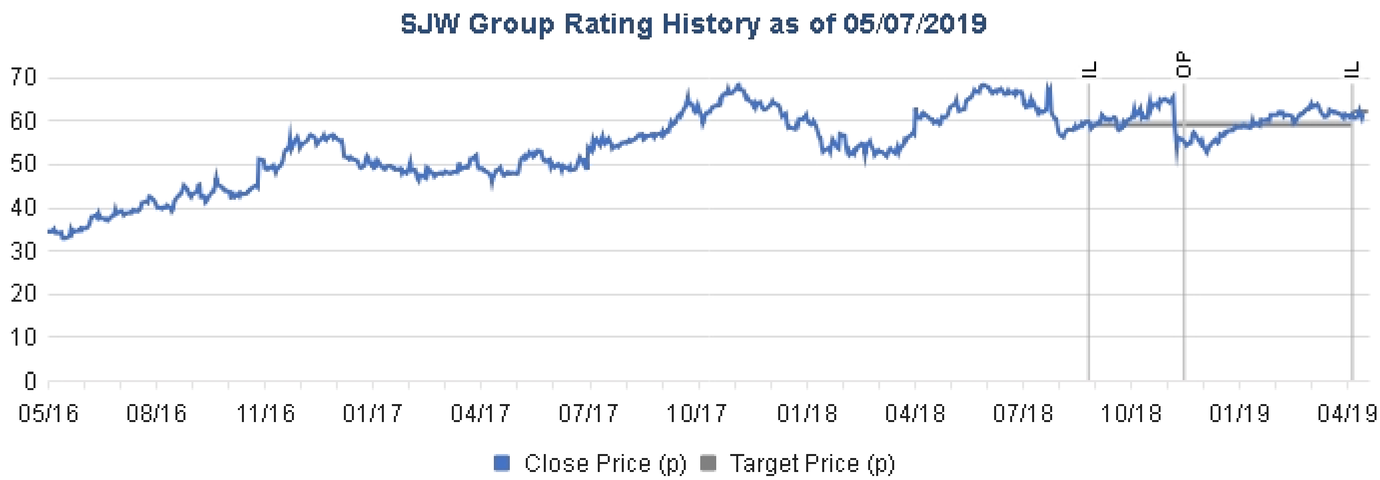

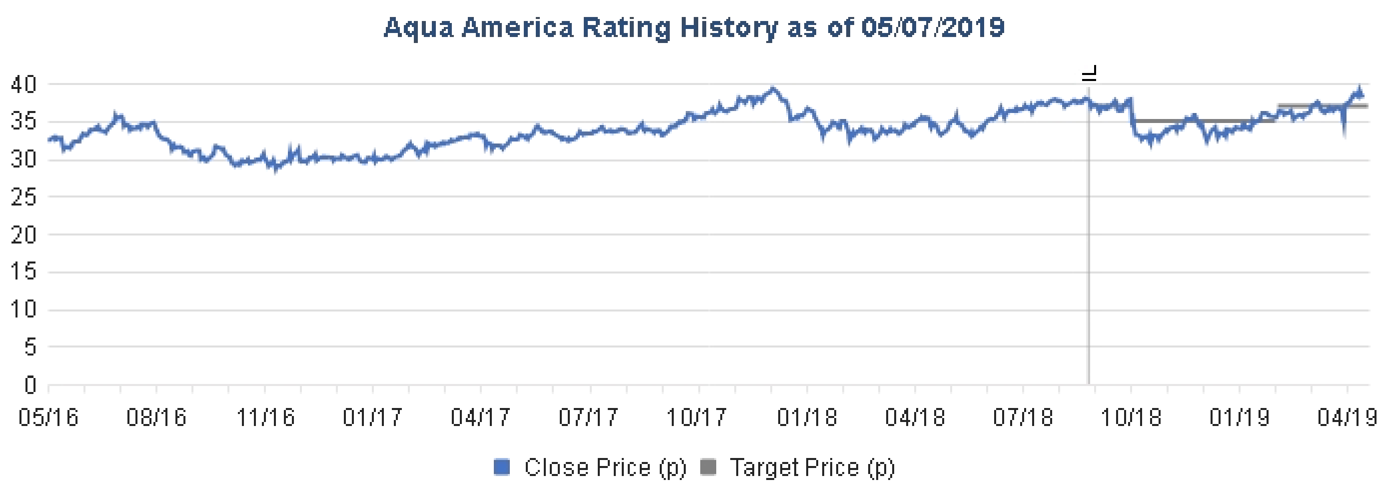

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B	Buy	OP	Outperform	L	Long	CS	Coverage Suspended
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